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Cronan O'Connell
Vice President-Federal Regulatory

EX PARTE

February 6, 2003

Ms. Marlene H. Dortch, Secretary
Federal Communications Commission
445 12th Street, S.W., TW-A325
Washington, DC 20554

Re: Ex Parte Presentation, CC Docket Nos. 01-338, 96-98, 98-147, *In the Matters of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers; Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Deployment of Wireline Services Offering Advanced Telecommunications Capability*

Dear Ms. Dortch:

Qwest submits this memorandum of A. Douglas Melamed in response to recent submissions by Professor Willig and Professor Kotlikoff on behalf of AT&T regarding the potential use of the Horizontal Merger Guidelines of the U.S. Department of Justice in crafting a definition of impairment.

In accordance with Commission Rule 47 C.F.R. §1.49(f), this *Ex Parte* is being filed electronically via the Commission's Electronic Comment Filing System for inclusion in the public record of the above-referenced proceedings pursuant to Commission Rule 47 C.F.R. §1.1206(b)(1).

/s/ Cronan O'Connell

cc:
Michael Powell (via email at mpowell@fcc.gov)
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Attachment

Ex Parte Presentation
UNE Triennial Review Proceeding – CC Docket No. 01-338
Local Competition Proceeding – CC Docket No. 96-98
Deployment of Advanced Wireline Services – CC Docket No. 98-147

Submission of A. Douglas Melamed,
On Behalf of Qwest Communications International Inc.

1. I have been a practicing attorney, specializing in antitrust law, for more than 25 years. I am currently a partner at Wilmer, Cutler & Pickering, an international law firm with headquarters in Washington, D.C., and co-chair of its Antitrust and Competition Practice Group. I assumed that position in May 2001, when I returned to the firm from the U.S. Department of Justice. While at the Justice Department, I served as Acting Assistant Attorney General in charge of the Antitrust Division from September 2000 until January 2001 and, before then, as Principal Deputy Assistant Attorney General for Antitrust from October 1996 until September 2000.

2. I am submitting this memorandum on behalf of Qwest Communications International Inc., in response to a recent submission in this proceeding by Professor Robert Willig.[1] Professor Willig, and in reliance on his analysis Professor Lawrence Kotlikoff,[2] craft a definition of "impairment" that purports to be based upon the Horizontal Merger Guidelines ("Guidelines") of the U.S. Department of Justice. I of course have substantial familiarity with

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1 Robert D. Willig, "Determining 'Impairment' Using the Horizontal Merger Guidelines' Entry Analysis (November 15, 2002).

2 Letter from Professor Kotlikoff to the Commissioners (January 21, 2003). Professor Willig's approach is also echoed in the WorldCom Response to SBC and BellSouth Critique of MiCRA Model at 5-6 (January 27, 2003).

those Guidelines as a result of my work both in the Antitrust Division and as a lawyer in private practice. The Guidelines do not support the arguments of Professors Willig and Kotlikoff.

3. Professor Willig states that the Guidelines "recognize that where a potential entrant suffers from any absolute cost disadvantage (5%) vis-a-vis the incumbent, entry will be less likely to occur." The implication, which Professor Kotlikoff makes explicit, is that a 5 percent cost disadvantage means "impairment" for purposes of the Telecommunications Act. I do not address whether, or if so to what extent, CLECs might have any kind of cost disadvantage as compared to ILECs. My comments address only the reliance of Professors Willig and Kotlikoff on the Guidelines.

4. There are three basic flaws in Professor Willig's argument. First, the Guidelines do not purport to set forth a general analysis of the conditions of entry. They are concerned only with a particular kind of scenario that can arise in connection with horizontal mergers, i.e., mergers among competitors. Specifically, the Guidelines address the question whether entry that would not take place premerger, because entry would not then be profitable, would become profitable and thus be likely to occur after a merger that is predicted to result in a significant price increase. The Guidelines explain that such entry might take place if, following the merger, the price increase and associated reduction in industry output creates sales opportunities to entrants that were not previously available. Guidelines § 3.0.

5. This of course is very different from the issue now before the Commission. While the Guidelines are concerned with the special problem of whether otherwise unprofitable entry would become profitable in the event of a price increase, the Commission is concerned more broadly with entry in the absence of those particular circumstances.

6. Second, Professor Willig's reference to the significance of "any absolute cost disadvantage (5%) vis-a-vis the incumbent" finds no support in the Guidelines. Professor Willig provides no citation for his reference, and for good reason. The Guidelines do not refer to a 5 percent cost disadvantage. Instead, as will be seen, they focus on profit opportunities, not comparative costs.

7. Nothing in the Guidelines supports the idea that "any absolute cost disadvantage" matters. To the contrary, the Guidelines state that "[a]n entry alternative is likely if it would be profitable at *premerger* prices, and if such prices could be secured by the entrant." Guidelines § 3.3 (emphasis added). In determining whether such entry would be profitable, the Guidelines direct attention to a comparison of "premerger prices, and all categories of costs associated with the entry alternative." *Id.* They thus contemplate an analysis like that described by Professor Shelanski,[3] which recognizes that cost disparities are common among competing businesses and that the profitability and likelihood of entry depend on the comparative advantages that help entrants over the long run and whether the industry structure enables them to earn positive margins, not just on specific cost disadvantages facing the entrant. Indeed, the discussion of entry in the Guidelines is notable for its lack of focus on comparative costs.

8. That brings me to the third and most important flaw in Professor Willig's analysis. The Guidelines are based on the premise that entry "is likely if it would be profitable." Guidelines § 3.3. They make clear that whether entry will be profitable depends, not on the relative costs of the incumbent and the entrant, but on a comparison between the entrant's costs and the prices it can anticipate. Thus, for example, the Guidelines state that profitability of entry

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[3] Letter from Howard A. Shelanski to William F. Mayer (January 14, 2003), Attachment 2 to Ex Parte Presentation of SBC (January 14, 2003).

"must be determined on the basis of premerger market prices" (§ 3.0) and that entry "is likely if it would be profitable at premerger prices and if such prices could be secured by the entrant." (§ 3.3).

9. In order to shift attention to a comparison of the entrant's costs with those of the incumbent, Professor Willig suggests broadly that a lower cost incumbent "could drop its prices below the entrant's costs" and still "remain profitable." But the Guidelines do not support either that general assertion or its significance, if true, for competitive analysis. The Guidelines deal with a special case: where a merger is predicted to result in an increase over prevailing prices and entry is contemplated in response to that price increase. In that context, it is realistic to expect that prices will fall back to premerger levels; because they are the existing prices, they have obviously been shown to be realistic prices for the incumbent. The Guidelines thus explain, almost tautologically, that "[e]ntry that is sufficient to counteract the competitive effects of concern [i.e., the post-merger price increase] will cause prices to fall to their premerger level or lower" and that the profitability, and thus the likelihood, of such entry must therefore "be determined on the basis of premerger market prices." Guidelines § 3.0.

10. The merger scenario contemplated by the Guidelines is largely irrelevant to the issue before the Commission here. In the merger case, the issue is whether the incumbents' temptation to increase prices in the future will be tempered by the threat of entry; because experience demonstrates the feasibility and, indeed, the likelihood of a resumption of existing, premerger prices, the likelihood of entry must be assessed assuming a continuation of those existing prices. By contrast, in the CLEC context, Professor Willig's analysis assumes that, even if entry would be profitable at existing prices, it will not occur if the incumbent's costs are lower than the entrants' costs on the ground that "the incumbent could drop its prices below the

entrant's costs." In other words, Professor Willig's analysis assumes that ILEC prices will drop to new, hypothetical levels in response to entry, whereas the Guidelines assume only a resumption of actual, premerger price levels.

11. In sum, Professor Willig's analysis is flawed. The merger Guidelines on which he relies direct attention to a comparison of the entrant's costs with the revenues it can be expected to earn. The Guidelines rest on the assumption, which is reasonable in the context of a merger, that merged incumbents can and will reduce prices to existing, premerger levels in response to new entry, but they provide no basis to predict that prices will be reduced below existing levels. Nothing in the Guidelines suggests that, even if ILEC costs were lower than CLEC costs, ILECs would reduce prices to levels that are below both existing, actual prices and CLEC costs in response to CLEC entry. The Guidelines thus do not support the argument that impairment can be found simply on the basis of a comparison of CLEC costs and ILEC costs.